

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **202340003**
Release Date: 10/6/2023
Index Number: 871.02-13

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

In Re:

Refer Reply To:
CC:INTL:B01
PLR-100588-23

Date:
July 07, 2023

Legend

Company =

Funds =

Dear :

This responds to the request dated December 28, 2022, submitted on your behalf by your authorized representative, in which you request that the Internal Revenue Service rule that certain income arising from the securities lending and sale-repurchase transactions described in this letter will constitute qualified interest income to Funds as defined in section 871(k)(1)(E) of the Internal Revenue Code of 1986, as amended (the Code).

The rulings contained in this letter are based upon facts and representations submitted by Company and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for a ruling. Verification of the factual information, representations, and other data may be required as a part of the audit process.

FACTS

Company is the sponsor and investment manager of Funds, a collection of exchange-traded funds. Each Fund qualifies as a regulated investment company (RIC) under Subchapter M, Part I of the Code. The Funds are formed as series of legal entities structured as series trusts and are each required to be registered with the U.S. Securities and Exchange Commission.

The Funds' investments include debt instruments that are issued by U.S. issuers in registered form. These debt instruments include U.S. Treasury securities and U.S. corporate bonds.

Certain Funds intend to enter into securities lending transactions in which a Fund lends a U.S. debt instrument to a counterparty in exchange for an obligation to return an identical debt instrument and payments for the use of the debt instrument. The transfer of the debt instrument will be made pursuant to a securities lending agreement that meets the requirements of section 1058(b). Accordingly, the transfer of the debt instrument and its return will not result in the recognition of gain or loss to the Fund. Additionally, certain Funds intend to enter into sale-repurchase transactions in which a Fund sells a particular U.S. debt instrument to a counterparty and agrees to purchase an identical debt instrument from the counterparty on a fixed date for a fixed price in the future. The counterparty will not be restricted from rehypothecating the debt instrument, subject to the terms and conditions of a lending agreement that meets the requirements of section 1058(b). During the term of the securities lending transaction or the sale-repurchase transaction, the Fund may receive substitute payments of amounts equivalent to any interest payments made on the debt instrument.

Company, on behalf of the Funds, will separately track the amounts of interest and substitute interest received by each Fund. Because the Funds are exchange-traded funds, Company and its affiliates, as managers of the Funds, are required to provide certain information to brokers on an annual basis to facilitate reporting to the Funds' shareholders on Forms 1099, 1042, and 1042-S. Company will report to brokers the percentage of each distribution that qualifies as an interest-related dividend under section 871(k)(1) or section 881(e)(1).

LAW AND ANALYSIS

Section 851(a) defines a RIC as any domestic corporation: (1) which, at all times during the taxable year, is registered under the Investment Company Act of 1940 (15 U.S.C. §§ 80a-1 to 80b-2), either as a management company or as a unit investment trust, or has in effect an election under such Act to be treated as a business development company, or (2) which is a common trust fund or similar fund excluded by section 3(c)(3) of such Act (15 U.S.C. § 80a-3(c)) from the definition of "investment company" and is not included in the definition of "common trust fund" by section 584(a). Section 851(b) provides additional requirements for qualifying as RIC. A RIC that meets the requirements of section 852(a), including certain distribution requirements, generally is taxed in accordance with Subchapter M, Part I of the Code.

A foreign shareholder generally treats a dividend received from a RIC as U.S. source fixed or determinable annual or periodical income subject to gross basis taxation under section 871(a) or section 881(a). A RIC is obligated to withhold tax from the dividend under section 1441 or section 1442, unless an exception to withholding applies.

Sections 871(k) and 881(e) provide that no tax is imposed under sections 871(a) and 881(a) on any interest-related dividend (as defined in section 871(k)(1)) received from a RIC that meets the requirements of section 852(a) for the taxable year in which the dividend is paid. The exemption under section 871(k) or section 881(e) does not apply to an interest-related dividend if any of the exceptions in section 871(k)(1)(B) or section 881(e)(1)(B) apply. These exceptions generally impose requirements with respect to interest earned by the RIC for the interest to qualify for the portfolio interest exemption under section 871(h) or section 881(c) had it been paid directly to the foreign shareholder. Sections 1441(c)(12) and 1442(a) provide that a RIC is not required to withhold tax from any amount exempt from the tax imposed by section 871(a) or section 881(a) by reason of section 871(k) or section 881(e).

Section 871(k)(1)(C)(i) provides that an interest-related dividend is any dividend, or part thereof, which is reported by the company as an interest-related dividend in written statements furnished to its shareholders. Section 871(k)(1)(C)(ii) limits the amount a RIC may designate as an interest-related dividend to the RIC's qualified net interest income for the taxable year.

Section 871(k)(1)(D) defines qualified net interest income as a RIC's qualified interest income reduced by the deductions properly allocable to such income.

Section 871(k)(1)(E) defines qualified interest income as the sum of the following amounts derived by a RIC from sources within the United States and includible in its gross income: (i) original issue discount on an obligation payable 183 days or less from the date of original issue; (ii) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under section 1271 et seq. and such other amounts as regulations may provide) on an obligation in registered form, except interest on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or contingent interest not treated as portfolio interest under the rules of section 871(h)(4); (iii) certain interest on deposits; and (iv) interest-related dividends from other RICs.

Treas. Reg. § 1.861-2(a)(7) (the "sourcing rule") provides that a substitute interest payment made with respect to a securities lending transaction or a sale-repurchase transaction is sourced in the same manner as the interest that accrues on the transferred securities for purposes of Treas. Reg. §§ 1.861-2 and 1.862-1.¹ A substitute interest payment is defined as a payment made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction of an amount equivalent to an interest payment that the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is defined as a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction, and a sale-repurchase transaction is defined as an agreement under

¹Treas. Reg. §§ 1.861-2 and 1.862-1 provide the general rules for sourcing interest for purposes of sections 861 and 862.

which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash.

Treas. Reg. §§ 1.871-7(b)(2) and 1.881-2(b)(2) (the “character rules”) provide that a substitute interest payment (as defined in Treas. Reg. § 1.861-2(a)(7)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction has the same character as interest income paid or accrued with respect to the terms of the transferred security for purposes of Treas. Reg. §§ 1.871-7 and 1.881-2.² A substitute interest payment made with respect to a debt instrument in registered form, the interest on which would qualify as portfolio interest under section 871(h) or section 881(c) in the hands of the lender, is treated as portfolio interest if the lender satisfies the documentation requirements under those sections.

Sections 871(k) and 881(e) were enacted to eliminate disparate tax treatment between a foreign person who invests directly in certain interest-bearing and other securities and a foreign person who invests in such securities indirectly through U.S. mutual funds, and to encourage U.S. financial institutions to form and operate their mutual funds within the United States. As stated in the legislative history to those sections: “[T]he Committee believes that, to the extent a RIC distributes to a foreign person a dividend attributable to amounts that would have been exempt from U.S. withholding tax had the foreign person received it directly (such as portfolio interest and capital gains, including short-term capital gains), such dividend similarly should be exempt from the U.S. gross-basis withholding tax.” H.R. Rep. No. 108-548, Part I, at 163-164 (2004). Thus, Congress intended to provide to investors in U.S. mutual funds the same exemptions from withholding tax with respect to certain types of income, including interest, available to foreign persons who directly invest in the same securities.

The preamble to Treasury Decision 8735, 62 Fed. Reg. 53498 (Oct. 14, 1997), states that the rules in Treas. Reg. §§ 1.861-2(a)(7), 1.871-7(b)(2), and 1.881-2(b)(2) are intended to source substitute interest payments using the general rules governing the source of interest under sections 861 and 862, and characterize such payments as interest for purposes of sections 864(c)(4)(B), 871, 881, 894, and 4948(a), and chapter 3 of the Code. The preamble explains that while the sourcing rule applies for all purposes of the Code, the character rules only apply with respect to “foreign taxpayers and only for limited purposes” so that they do not affect existing guidance applicable to both U.S. and foreign taxpayers concerning the characterization of substitute payments for purposes of other sections. Thus, while the character rules were intentionally limited in scope, they are intended to apply when a substitute interest payment is made to a foreign person subject to tax under section 871(a) or section 881(a), including for

²Treas. Reg. §§ 1.871-7 and 1.881-2 provide the general rules imposing gross basis taxation under sections 871(a) and 881(a) on a foreign person that receives U.S. source fixed or determinable annual or periodical income. Because the character rules apply for purposes of these operative rules, it is appropriate to also apply the character rules for purposes of any applicable exception to those rules, such as section 871(k) or section 881(e).

purposes of applying the portfolio interest exemption under section 871(h) or section 881(c).

In this case, the substitute interest payments will be made to the Funds, which are domestic corporations for purposes of the Code. However, if the substitute payments were made directly to the foreign shareholders of the Fund, they would retain their character as interest under Treas. Reg. §§ 1.871-7(b)(2) and 1.881-2(b)(2) and would qualify as portfolio interest under section 871(h) or section 881(c). Because sections 871(k) and 881(e) are intended to provide the foreign shareholders of a RIC with the same exemptions from tax that would have applied had they received the interest directly, it is appropriate to treat the substitute interest payments as interest for purposes of computing each Fund's qualified interest income under section 871(k)(1)(E).

CONCLUSION

Based on the facts as represented, it is concluded that substitute interest payments received by the Funds in connection with the securities lending and sale-repurchase transactions described in this letter involving U.S. debt instruments in registered form constitute qualified interest income as defined in section 871(k)(1)(E). This ruling only applies to substitute interest payments that, if treated as interest, would otherwise meet the requirements to be qualified interest income under section 871(k)(1)(E). The substitute interest payments are treated as interest solely for the purpose of computing a Fund's qualified interest income under section 871(k)(1)(E).

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Subin Seth
Senior Counsel, Branch 1
Associate Chief Counsel (International)

Enclosure:
Copy for 6110 Purposes

cc: